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SUBJECT: AIRLINES IN RUSSIAN FAR EAST SKIDDING TO A STOP

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¶1. Summary. The airline industry in the Far East continues its downward trajectory. Dalavia has become the latest in a series of bankruptcies in the industry. Vladivostok Avia remains relatively strong, but may become a tempting takeover target. Ticket prices will remain prohibitively expensive as competition

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dwindles and fuel prices remain high.

Dalavia in Trouble

¶2. Khabarovsk-based air carrier Dalavia is the latest airline serving the Russian Far East to file for bankruptcy, following Magadan Air, Krasnoyarsk Air, and Domodedovo. Things came to a head for long-troubled Dalavia when airports in several cities, including in its home base Khabarovsk, began refusing to service its fleet after the company defaulted on its multi-million-dollar fuel debt to the airports. As a result, in September the company was forced to cancel all of its domestic and international flights, and has ceased selling tickets. In September, Khabarovsk airport refused to grant landing rights to in-flight Dalavia planes which then had to be diverted to other airports.

¶3. Dalavia General Director Valeriy Chichilimov addressed the

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media on Sep 22, blaming the company's troubles on its aging fleet, malfunctioning engines on its new Tupolev-214s, "unprecedented fuel prices," and competitors who "operate fuel-efficient US- and Western-made aircraft." Chichilimov also confirmed that authorities have placed liens on the company's accounts to pay fuel debts to Khabarovsk airport. Not surprisingly, the company is also facing legal problems. The regional Prosecutors Office launched a criminal investigation against Dalavia management on suspicion of "illegal entrepreneurship," misuse of funds, and illegal withholding of wages. Dalavia is fully government-owned and operated flights domestically and to Japan, South Korea, and China. Its fleet of 27 Tupolevs and Antonovs carried 694,000 passengers in 2007.

In Steps Vladavia

¶4. In early September, the government announced plans to merge Dalavia into Vladivostok-based Vladavia, which has begun

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carrying ticketed Dalavia passengers and will pick up all of Dalavia's international and domestic routes. As part of the plan, Vladavia will have access to Dalavia funds remaining from past ticket sales. Vladavia Deputy Director Igor Bagelfer will reportedly take over as Dalavia's General Director. Management at Vladavia has so far refrained from commenting on the merger, saying that they "have not received any official documentation regarding the matter." Consulate FSN staff was unable to illicit comment from our contact at Dalavia.

15. Vladavia operates 70 flights a week to domestic and Pacific Rim countries and is considered the healthiest of the Russian Far East's regional carriers. It is 51 percent government-owned. The company carried 776,000 passengers in 2007, and began seasonal service from Kamchatka to Anchorage, Alaska, in July this year. It has 30 airplanes in its fleet, including the new fuel-efficient long-range TU-204-300.

Past Maneuvering Did Little to Improve Situation

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16. In 2006 Aeroflot had its own plans for the Russian Far East, proposing a consolidation of all Far East carriers into one regional airline to be called AEROFLOT-VOSTOK, with Aeroflot holding 70 percent of the new airline's shares. The move had been approved by federal regulators, and Dalavia agreed to the plan. Vladavia held out against the proposal, and Vladavia's main shareholder, the federal government, let the plan lapse. Then-President Putin chose not to issue a presidential decree that could have forced the merger.

17. Despite heavy government involvement and even ownership, Vladavia and Dalavia had been subject to government intervention. In an effort to lower prices and cut monopoly powers of airlines owning their own hub airports, the federal government forced Dalavia in 2007 and Vladavia in early 2008 to spin off their airport operations from their passenger service companies. The plan did not result in more competition and lower prices as hoped -- competition did not increase in

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Khabarovsk, and Vladavia still charges more for its two-hour hops to Seoul and Niigata than U.S. carriers charge for most trans-Pacific flights.

Comment

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18. If the Kremlin were to again get involved in the deteriorating situation in the Russian Far East's aviation industry, it would likely not be to prop up ailing companies, but to take over the most healthy. If Vladavia were to remain solvent, it could end up as a target for Rostehnologii, the conglomerate of over 200 firms led by close Putin associate Sergey Chemezov. The holding company has reportedly been looking for entry into the airline industry. Whatever the fate of Vladavia, one of the main problems hindering development in the East is the high cost of transportation, and with the string of recent airline bankruptcies, the situation will not improve soon.

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